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Mr. William Kennard, Esq.
General Counsel
Federal Communications Commission
1919 M Street, N.W. -- Room 614
Washington, D.C. 20554

Re: Sections 251 and 252 of the 1996 Act

Dear Mr. Kennard:

Attached is an analysis of a number of issues that have been raised in connection with sections 251 and 252 of the new Act. In particular, this paper addresses several arguments that have been advanced by the incumbent long distance industry, and with respect to each briefly outlines the legal, economic and policy reasons why their arguments are misplaced.

I hope this is useful as the Commission endeavors to implement these provisions of the Act, and would, of course, be glad to address any questions that you or others may have concerning the attached.

Sincerely,

Michael E. Glover
(f.m)

Attachment

cc: Mr. Nakahata
Mr. Casserly
Ms. Belvin
Mr. Gonzalez
Ms. Keeney
Mr. Metzger
Mr. Welch
Mr. Schlichting
Mr. Ellen
Mr. Pepper
Mr. Maxwell
Mr. Farrell
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**PROMOTING FACILITIES-BASED COMPETITION
IN ALL MARKETS: A RESPONSE TO THE
LONG DISTANCE INCUMBENTS**

Bell Atlantic Telephone Companies

April 1996

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**PROMOTING FACILITIES-BASED COMPETITION
IN ALL MARKETS: A RESPONSE TO THE
LONG DISTANCE INCUMBENTS**

In a white paper recently submitted to the Federal Communications Commission, the incumbent long distance industry purports to provide “a roadmap for implementation of some of the key statutory provisions.” In reality, the paper merely leads the reader on a prolonged detour designed to revisit policy choices previously made by Congress and this Commission.

The long distance carriers’ objective is three-fold. First, they hope to circumvent the Commission’s existing access charge regime. Second, they would like to enter the local market using only existing local exchange networks at rates that do not cover the total costs of operating those networks. This not only would jeopardize universal service objectives by denying local exchange carriers the ability to recover the costs of their ubiquitous networks, but also would deter entry by legitimate facilities-based competitors. Third, the long distance incumbents claim that, to the extent their proposal does deter entry by facilities-based local competitors, the absence of such competition should be relied upon to block new entry into the long distance business. This would leave them free to continue their pattern of lock-step price increases, despite steadily declining access charges. On all scores, however, their arguments run counter to the Act and to sound public policy.

I. CORRECT FCC IMPLEMENTATION IS CRITICAL TO NEW FACILITIES-BASED COMPETITION IN ALL MARKETS, INCLUDING LONG DISTANCE

By passing the 1996 Act, Congress sought to promote the development of facilities-based competition in all the various segments of the telecommunications industry. On the telephone side of the industry, it does so in two ways

In the local exchange market, the Act eliminates legal barriers to facilities-based competition, and permits new entrants to interconnect their competing local exchange networks

with those of incumbent LECs. In addition, the Act allows these interconnectors to supplement their own facilities by obtaining access to elements of the incumbent's network. In this way, the Act ensures the interoperability of the competing local exchange networks, and allows new entrants who need to augment their own facilities (such as cable companies or CAPs) to nonetheless enter the local market on a facilities basis and begin to compete. In addition, to permit entry where no competing facilities are in place, the Act allows non-facilities-based carriers to enter the market by reselling services of the LEC.

Likewise, in the long distance market, the Act also eliminates legal barriers to facilities-based competition from the Bell companies as soon as they comply with the Act's requirement to open their local networks to competitors. When they are in compliance in a particular state, whether because they are providing interconnection under an agreement entered into with a local competitor or because they have filed a statement of generally applicable terms for such interconnection, they are entitled simultaneously to enter the in-region long distance business.

Although the long distance incumbents pay lip service to the desire to promote facilities-based competition, they nonetheless ask the Commission to implement the Act in a way that undermines that very goal. Rather than promoting facilities-based competition in all markets, their arguments are designed to obtain an advantage for themselves over legitimate facilities-based entrants in the local market, while foreclosing entry by new competitors into the long distance market.

The long distance carriers' argument boils down to a claim that LECs should be forced to provide access service to interexchange carriers at prices that equal their so-called "economic cost," an undefined term that appears to mean some measure of "direct" or "incremental" cost. Whether they achieve this directly or, as they now argue, indirectly by

buying network elements and assembling them to provide end-to-end service using only the LEC's existing network, the result is to circumvent the Commission's access charge regime. The impact of allowing them to do so is two-fold.

First, access charges today cover not only the direct cost of providing access and a return on the network's investment, but also contribute to the common costs of operating the joint use network. In an industry such as telecommunications that is characterized by large fixed infrastructure investments and economies of scale and scope, this type of rate structure is critical. If all services were priced at or near the direct or incremental cost of providing those services, the business as a whole would not cover its total cost and would fail. The Commission itself has recognized this very fact and set prices for the local and long distance segments alike to permit recovery of these costs. In fact, the long distance carriers today routinely price their own services at two, three, or more times their incremental cost (including access), and long distance prices continue to rise despite steadily declining access charges.

This problem of recovering joint and common costs is particularly acute in the local telephone business where prices for local exchange services have been kept artificially low -- and in many instances set at rates that are even below incremental cost. LECs historically have had to recover the joint and common costs of operating their ubiquitous networks in large part from interexchange access (along with toll and vertical services). In an increasingly competitive marketplace, the existing access charge regime needs to be reformed to impose more costs on those who cause them to be incurred and to send correct economic signals to new entrants -- for example, by increasing the cap on subscriber line charges. But this cannot be done in isolation, as the long distance carriers argue, by simply mandating that access rates be set equal to incremental cost. The result would be to deny LECs the ability to

recover the total cost of operating their ubiquitous networks, raising serious confiscation issues, while at the same time jeopardizing universal service objectives.

Second, allowing the long distance incumbents to buy network elements at incremental cost and assemble them to provide end-to-end services would deter entry by legitimate facilities-based competitors. Like the incumbent LECs, these new entrants will not only have to recover the incremental cost of individual services, but also will have to recover the joint and common costs of their own joint use facilities. The long distance carriers on the other hand, want to provide service without having to incur the cost of deploying facilities, and by paying only the incremental cost of individual elements of the LECs' networks. This would provide them with an enormous advantage over any facilities-based carrier.

II. KEY PROVISIONS OF THE LEGISLATION

As an initial matter, the long distance carriers base their various arguments on section 251 of the Act, but fundamentally misconstrue the scope of this section. Section 251 fosters competition for local telephone service by codifying the local incumbents' duty to interconnect with competing local telephone providers that offer local exchange and exchange access services. This section does not change the terms and conditions under which incumbents provide these same services, and does not apply to the incumbents' existing access services provided to interexchange carriers.

Just as the arguments of the long distance carriers are flawed at the general level, they also are flawed in their interpretation of individual provisions.

A. Interconnection With Local Telephone Competitors

The opening gambit by the long distance incumbents is to claim that the interconnection requirement in section 251(c)(2) applies to the LECs' interexchange access services. As a result, the long distance incumbents claim that they can now circumvent the

Commission's access charge regime by negotiating new interstate access rates that are subject only to state review. This is so, they claim, because long distance carriers qualify as "telecommunications carriers" who benefit from section 251's interconnection requirement. But they are looking at the wrong end of the elephant. The question is not who gets to interconnect under section 251, but to do what. And the long distance carriers carefully avoid addressing the part of the statute that answers the real question here.

The plain language of the section 251(c) confirms that the interconnection requirement applies only with respect to a competitor that is providing its own local exchange and exchange access services. By its terms, section 251(c)(2) expressly applies only with respect to interconnection -- i.e., the physical linking of the competing providers' network facilities and equipment -- "for the transmission and routing of telephone exchange service and exchange access" provided by those competitors. Section 251(c)(2)(A) (emphasis added). In fact, the very definition of exchange access makes clear that these interconnectors must be "offering" access to exchange services or facilities, not purchasing such access. Section 3(16).

In contrast, when a LEC provides access services to an interexchange carrier, the interexchange carrier is not connecting to the local exchange network in order to transmit or route its own local exchange service or exchange access service. The interexchange carrier is providing interexchange service, and the LEC is providing local exchange service and exchange access for the call. Section 251(c)(2) -- and the requirements of section 252 that flow with section 251 -- do not apply in these circumstances.

Moreover, the long distance carrier's attempt to obviate the Commission's access charge regime is contrary to the statute and legislative history in other respects. If section 251(c) applies to access, then the Commission is divested of jurisdiction over these services. Instead, access rates would be set by negotiated agreements between the parties,

subject only to State review under section 252. Congress was obviously aware of the existing regulatory regime, however, and would not have transferred regulatory jurisdiction over the \$20 billion interstate access business to the states without saying so explicitly and giving a good reason for doing so. Instead, Congress expressly preserved the Commission's authority under Section 201 of the Communications Act, which provides the basis for the Commission's exercise of jurisdiction over the interstate access market. Section 251(i).

Finally, Section 251(g) requires local carriers to continue to provide exchange access service to interexchange carriers under the Commission's existing rules -- including those governing the "receipt of compensation" -- until such rules are expressly superseded. This demonstrates that the Act does not automatically replace the access charge regime, and the Commission certainly should not do so until various approaches to access reform have been explored and new universal service support mechanisms are established.

B. Non-discriminatory Access by Interconnectors to Network Elements

Recognizing the weakness of their interconnection argument, the long distance incumbents now emphasize an argument that section 251(c)(3) nonetheless creates a broad "unbundled access" requirement that allows them to do indirectly what the Act does not permit them to do directly. This provision, they claim, allows long distance carriers with no local exchange facilities of their own to buy network elements from the incumbent LEC, and to "combine" them to provide end-to-end local exchange and exchange access. The long distance incumbents should then be permitted to use these recombined elements, so the argument goes, to provide access to themselves, again effectively circumventing the Commission's access charge regime. Once more, however, long distance carriers fail to focus on what the statute actually says, and what it was intended to achieve.

In reality, the statute does not say, as the long distance incumbents claim, that the LECs must provide "unbundled access" or "unbundled network elements." Instead, it says something quite different, namely, that LECs must provide "nondiscriminatory access to network elements on an unbundled basis at any technically feasible point." Section 251(c)(3) (emphasis added). But the only way for another carrier to obtain access to a LEC's network at any given point is by interconnecting its own facilities to those of the incumbent; otherwise, it is not getting access to the network at any "point." And, as shown above, the interconnecting carrier must be providing competing local telephone services and the facilities it interconnects must be local exchange and exchange access facilities -- not interexchange facilities.

As a result, a careful reading of section 251(c)(3) shows that it was not intended as the long distance incumbents claim, to apply in instances where the interconnection provision does not, and that the two sections can only be reasonably interpreted as being coextensive in their application.

The legislative history confirms that Sections 251(c)(2) and (3) must be read together to permit new entrants to connect their local exchange network facilities with those of the incumbent, and to supplement their own facilities with network elements obtained from the incumbent. According to the Senate Report, for example, the provision requiring access to network elements clarifies the "types of interconnection" that are required. Senate Report at 19. And the Conference Report further explains the operation of these provisions as follows: "[I]t is unlikely that competitors will have a fully redundant network in place when they initially offer local service, because the investment necessary is so significant. Some facilities and capabilities (e.g., central office switching) will likely need to be obtained from the incumbent local exchange carrier as network elements pursuant to new section 251." Conf. Report at 148 (emphasis added).

Moreover, this same careful reading of the statute also explains why the long distance carriers are wrong when they claim they can “combine” network elements to provide access to themselves using only the LEC’s facilities. On the contrary, if the long distance carriers have no local exchange facilities of their own to interconnect, then sections 251(c)(2) and (c)(3) simply do not apply.

Nor is the result changed by virtue of the fact that the statute allows local competitors to “combine” network elements, since this merely begs the question, combine with what? Given the context and the legislative history, the most reasonable reading is that this provision allows new entrants to combine one or more network elements obtained from the incumbent with some of their own local exchange facilities in order to provide a competing facilities-based service. In contrast, if long distance carriers choose to enter the local market using the facilities and services of the incumbent LEC, they must do so through the resale provision discussed below and its separate pricing standard.

The long distance incumbents also attempt to redefine what constitutes a network element in a way that is far broader than the statute. For example, they claim that so-called “vertical” services that LECs offer at retail to end users, such as local usage or custom calling services, should be classified as network elements. But these are “telecommunications services” under the Act, not elements of the LECs’ networks.

In reality, the Act’s definition of a “network element” is designed to require, where technically feasible, access to the physical elements of the LECs’ networks, including to network features, functions and capabilities that permit the physical delivery of a call to a local customer. Section 252(d)(2)(B) Congress was quite specific in describing the types of features, functions and capabilities it had in mind in defining “network element,” e.g., “subscriber numbers, databases, signaling systems, and information sufficient for billing and

collection or used in the transmission, routing, or other provision of a telecommunications service.” Section 3(29). These are all necessary means of providing basic telephone service to the public, not services in and of themselves. As a result, if the long distance carriers want to purchase vertical or other existing services, they can, but not as unbundled network elements. They must do so under the resale provision of the Act

Indeed, a different result with respect to either of the above issues concerning the scope of 251(c)(3) effectively would read the resale provision out of the Act, since the long distance carriers could evade the resale provision and its separate pricing standard at will. If long distance carriers can purchase network elements at incremental cost, as they claim, this is likely to always be below the wholesale price of retail less avoided costs for any services that are remunerative today. (This is true because retail rates for these services include contribution to joint and common costs). As a result, the long distance carriers would always buy these services as network elements, and the separate pricing standard for the resale of these services would become meaningless if it could be evaded so easily.

Moreover, contrary to the claims of the long distance incumbents, the definition of network elements does not extend to a LEC’s administrative, operational, or marketing support mechanisms and personnel. There is no sense in which these functions can be characterized as physical elements or related features and functions of a LEC’s network, and they simply are not covered by the Act. Nor does the Act require access to a LEC’s back office operations, such as billing and collection or marketing services, in order to permit a competitor to provide the same “quality” of local service as is offered by the LEC. While a LEC may be willing to negotiate with a competitors to provide those services, it is not required to do so by the Act.

C. Pricing of Interconnection and Access to Network Elements Based on Total Network Costs

As an initial matter, it is important to clarify the context in which the Act's pricing standard applies. Under the Act, the price for interconnection and access to network elements is to be determined in the first instance by negotiated agreements between the parties, subject to review by the states. Sections 251(c)(1), 252(a). If, and only if, an agreement is not reached, then either party may petition the state commission to arbitrate any open issue, including price. The pricing standard of section 252(d) applies in the context of these arbitrations where the state commission must make a determination of the just and reasonable rates.

According to the long distance carriers, the standard that applies in this context requires prices for interconnection and access to network elements equal to the "economic cost" to provide them, a term that appears to refer to some measure of "direct" or "incremental" cost. This is so, they claim, because the Act prohibits use of other cost standards, and because economic cost supposedly "already includes a reasonable profit." They are wrong on both scores.

First, the Act does not mandate any particular measure of cost and does not mandate that rates be set at cost. On the contrary, it provides only that state arbitrators should set rates "based on cost," plus a "reasonable profit." Section 252(d)(1)(i) and (d)(1)(B). Moreover, incremental cost may be the appropriate standard for use in setting price floors, but regulators and economists have long recognized that, if rates for all -- or even many -- services were set at incremental cost, they would not recover the total cost of operating the LECs' joint use networks. In the long term, the business would fail. This is particularly true in today's environment where many of the LEC's local exchange services already contribute little, if anything, to covering the common cost of the joint use network. In fact, in many places, local

exchange services continue to be required to be priced below their incremental cost for social policy reasons. Moreover, to the extent the cost of equipment may have declined over time, a purely forward looking measure of incremental cost would deny LECs the ability to recover their historic investment. This would raise serious confiscation issues, and deter further investment in the network, contrary to the commands of section 706 of the new Act.

As a result, prices are routinely set by this Commission and others based on incremental cost plus some contribution to the total costs of constructing and operating the LECs' joint use networks. These practices are perfectly consistent with the Act. They produce prices that are "based on" the total cost to provide service, and this is all the Act requires. In fact, the long distance carriers' only response is to point out that the Act bans resort to a "rate-of-return or other rate-based proceeding." Section 252(d)(1)(A). But this merely bars state commissions from initiating a traditional "rate case" or other proceeding that would require burdensome rate-of-return style cost showings. It does not, as the long distance incumbents claim, change the relevant cost standard. To the contrary, it underscores Congressional support for the "cost plus contribution" approach to setting rates under existing price cap regulatory schemes, which are the alternative to the rate-of-return proceedings Congress forbade.

Second, setting prices equal to "economic cost" does not, as the long distance incumbents claim, allow LECs to earn a reasonable profit. As an initial matter, not all measures of incremental cost include a component to cover a LEC's cost of capital, and to allow it to earn a "profit" in an economic sense. Moreover, so long as all prices are set equal to incremental cost, even allowing the LECs a true profit above incremental cost on individual services would still deny them a reasonable profit for the company as a whole. This is true because they would

still be denied the ability to recover the common costs of operating their networks, as well as denied the ability to earn a reasonable profit on those costs.

Finally, setting rates at incremental costs for interexchange access and for network elements that can be assembled to provide end-to-end service will not, as the long distance carriers claim, create incentives for new entrants to build their own facilities. It will do quite the opposite. If new entrants build their own facilities, they too will have to price their various services at levels that will allow them to recover the total costs of their joint use networks. But as long as AT&T, MCI and the rest of the long distance cabal can buy these services at incremental cost, they do not face the same problem. As a result, in the long run, no facilities-based provider, whether the incumbent or a new entrant, would be able to compete on equal terms with the long distance carriers. Ironically, the net result is to allow the long distance carriers to take traffic away from the incumbents without investing a dime in their facilities, and to deter entry by legitimate facilities-based competitors.

D. Resale of Services Offered at Retail

The Act also includes a separate resale provision that applies when carriers enter the local market by reselling retail telecommunications services of the incumbent LEC. Section 251(c)(4). The resale provision, and the separate pricing standard that accompanies it, allows competitors to buy at wholesale rates any telecommunications service that the LEC "provides at retail" to end user subscribers. Section 251(c)(4)(A).

The Act also contains a separate pricing standard that is tailored to the unique circumstances under which the resale provision applies. Services available for resale must be provided to competitors at wholesale rates that are based on the retail rates charged to subscribers, excluding any portion of those rates attributable to costs that "will be avoided." Section 252(d)(3) (emphasis added). This provides new entrants with the ability to enter the

market on a resale basis as their local networks are being constructed, but at the same time preserves their incentives to deploy competing facilities where doing so will enable them to provide service at a lower cost than they can achieve by merely buying services wholesale.

According to the long distance carriers, it is "essential" for the Commission to distinguish resellers providing services under the resale provision from carriers who purchase access to network elements under section 251(c)(2). On this score, the long distance carriers are correct. But, the distinction they draw is the wrong one.

According to the long distance incumbents, they should be permitted to evade the pricing standard that applies to resellers at will through the simple expedient of buying network elements and assembling them to provide retail services using only the LECs network. As shown above, however, section 251(c)(2) applies when a new entrant interconnects some of its own local exchange facilities with those of the incumbent. It does not apply to a new entrant with none of its own facilities. Nor would the statute's objective of promoting facilities-based competition be served if it did apply in that circumstance. In contrast, when a new entrant provides service merely by using the incumbent's network, then it is a reseller and is subject to the terms of the resale provision. If competitors could merely buy piece parts of the incumbent's network at incremental cost and assemble them to provide service, as the long distance incumbents claim, they would have no incentive ever to deploy their own facilities.

Moreover, the long distance carriers read the resale provision too broadly even in those instances where it does apply. They claim that LECs not only must make their retail services available under the resale provision, but must also provide administrative, operational or other support for these services at discounted prices. But their claim cannot be squared with the statute.

The resale provision is expressly limited to the “telecommunications service” that a LEC provides at retail to its end user subscribers. Section 251(c)(4). It does not include administrative, operational, or marketing support, or other services provided only to carriers, not to end user subscribers. In fact, the point of the resale provision is to allow new entrants to compete by finding ways to perform these very functions more efficiently than the LECs. And while it is certainly true that a LEC can voluntarily agree to provide these functions to resellers during the negotiation process, it is not required to do so by the Act. If the LEC does choose to provide these functions, it must be compensated at the market price of doing so.

E. Reciprocal Compensation for Transport and Termination of Traffic

In addition to the duties of incumbents described above, the Act also imposes a duty on all local exchange carriers -- incumbents and new entrants alike -- to establish reciprocal compensation arrangements for the transport and termination of traffic. Section 251(b)(5). As in the case of the price for interconnection and access to network elements, these mutual compensation arrangements are subject, in the first instance, to negotiations between the parties, and to State review under the procedures of section 252.

The duty to establish reciprocal compensation arrangements is accompanied by a separate pricing standard that is tailored to the circumstances in which it applies. Specifically, the Act provides that a State commission shall not consider such arrangements to be just and reasonable unless they provide for the mutual and reciprocal recovery by each carrier of the additional costs incurred to terminate calls that originate on the other carrier's network. Section 252(d)(2)(A). Unlike the pricing standard for interconnection and access to network elements, this provision does not require that the price ultimately set be “based on cost,” but instead merely establishes a price minimum. The general rule is that the parties must, at a minimum, be able to recover their costs on a reciprocal basis. Precisely because these arrangements are

reciprocal, however, the Act establishes only a minimum, and leaves it to the parties to determine the precise terms above this minimum.

The Act also provides a limited exception to this general rule. Namely, the Act makes clear that it does not “preclude” arrangements between the parties that allow the recovery of cost through the “offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements)” Section 252(d)(2)(B)(i) (emphasis added). By its very terms, however, this provision creates an exception to the right to recover the costs of transporting and terminating calls only where the parties voluntarily waive this right. It does not permit arrangements that deny carriers this right to be imposed by regulatory mandate.

F. The Standards for InterLATA Entry

In an effort to preserve their cozy oligopoly, the long distance incumbents severely distort the Act’s standards for Bell companies to obtain approval to enter the in-region business in several respects. Their objective, of course, is to block competitive entry, leaving them free to continue their pattern of lock-step price increases -- the most recent example of which occurred in February of this year when AT&T and MCI actually went so far as to increase prices in parallel on the same day.

First, the long distance incumbents claim that the competitive checklist in section 271 requires the Bell companies’ exchange access rates to be set at incremental cost before long distance entry is permitted. In reality, however, the provision they cite merely requires a Bell company to “offer” interconnection and access to network elements “in accordance with the requirements” of section 251. Section 271(c)(2)(B). But as demonstrated above, section 251 does not apply to the access services an incumbent LEC provides to interexchange carriers, and does not require rates to be set at incremental cost.

Second, the long distance incumbents argue that section 271 allows Bell companies to obtain interLATA relief only where they face “meaningful facilities-based competition.” This is simply wrong. The Act provides for interLATA relief in a given state either where a Bell company has an agreement under which it is providing interconnection and access to network facilities to an operational local competitor, or where it has a filed statement of the terms under which it will do so that is in effect. Section 271(c)(1) and (c)(2). As a result, under the statement of terms track, the Act provides for interLata relief even in the complete absence of a local facilities-based competitor. This result, moreover, is perfectly consistent with the purpose behind the requirements of section 271. Contrary to the claims of the long distance incumbents, the purpose is not to ensure that “access rates must be subject to considerable market pressure” before competition is permitted in the long distance business, and does not require that a competitor be operating over any particular geographic scope. Instead, the purpose is to ensure that the incumbent has in fact opened its network to interconnection by others so that competitive entry can occur in the local market simultaneously with the introduction of new competition into the long distance market.

Third, they claim that in-region interLata relief is not in the public interest if Bell companies include only the economic cost of access in their intralata rates, while competitors must pay a higher tariffed rate. This argument is wrong on the economics of the issue, because it would withhold from consumers the efficiency benefits inherent in Bell companies' provision of both long distance and local service. In fact, this is no different than the long distance industry where AT&T and MCI are free to base their own prices on costs, but long distance resellers must pay a higher tariffed rate. More fundamentally, the argument is moot. For the near term, the Act requires the Bell companies to provide in-region interLata services through a separate affiliate, and to charge that affiliate the same amount for exchange access that it charges

unaffiliated interexchange carriers. As a result, there can be no “disparity” between what the Bell companies’ interLata affiliate pays and what their competitors pay, and there is no issue to address.